806 KAR 3:160. Life and health reinsurance agreements.

RELATES TO: KRS 304.3-240, 304.5-120
STATUTORY AUTHORITY: KRS 304.2-110(1)
NECESSITY, FUNCTION, AND CONFORMITY: KRS 304.2-110 provides that the Executive Director of Insurance may promulgate administrative regulations to implement the Kentucky Insurance Code, KRS Chapter 304. This administrative regulation restricts the use of life and health reinsurance agreements as "surplus relief" if the effect is to distort reporting of the life and health insurer's true financial condition, take credit for or a reduction from liability for reinsurance agreements which do not involve a transfer of risk, and which conceal the fact that the insurer is in hazardous financial condition.

Section 1. Purpose and Scope. (1) This administrative regulation shall apply to all:
(a) Domestic life and health insurers;
(b) Other authorized life and health insurers that are not subject to a substantially similar administrative regulation in their domiciliary state; and
(c) Licensed property and casualty insurers with respect to their health business.
(2) This administrative regulation shall not apply to:
(a) Assumption reinsurance;
(b) Yearly renewable term reinsurance; or
(c) Certain nonproportional reinsurance such as stop loss or catastrophe reinsurance.

Section 2. Accounting Requirements. (1) An insurer shall not, for reinsurance ceded, reduce a liability or establish an asset in a financial statement filed with the Office of Insurance if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:
(a) The primary effect of the reinsurance agreement is to transfer deficiency reserves or excess interest reserves to the books of the reinsurer for a risk charge, and the agreement does not provide for material participation by the reinsurer in one (1) or more of the following risks: mortality, morbidity, investment, or surrender benefit;
(b) The reserve credit taken by the ceding insurer does not comply with:
1. The Kentucky Insurance Code, KRS Chapter 304; or
2. Office of Insurance administrative regulations; or
3. Actuarial Standards of Practice of the Actuarial Standards Board;
(c) The reserve credit taken by the ceding insurer is greater than the underlying reserve of the ceding insurer supporting the policy obligations transferred under the reinsurance agreement;
(d)1. Except as provided by subparagraphs 2 and 3 of this paragraph, the ceding insurer is required to reimburse the reinsurer for negative experience under the reinsurance agreement;
2. Offsetting experience refunds against the current and prior years' losses, or payment by the ceding insurer of an amount equal to the current and prior years' losses upon voluntary termination of in-force reinsurance by the ceding insurer shall not be considered a reimbursement to the reinsurer for negative experience.
3. Voluntary termination shall not include a termination that occurs because of unreasonable provisions which allow the reinsurer to reduce its risk under the agreement.
(e)1. Except as provided by subparagraph 2 of this paragraph, the ceding insurer may be deprived of surplus at the reinsurer's option or automatically upon occurrence of some event, such as insolvency of the ceding insurer.
2. Termination of the reinsurance agreement by the reinsurer for nonpayment of reinsurance premiums or other amounts due such as modified coinsurance reserve adjustments, interest and adjustments on funds withheld, and tax reimbursements, shall not be considered to be a deprivation

of surplus.

(f) The ceding insurer must, at specific points in time scheduled in the agreement, terminate, or automatically recapture, all or part of the reinsurance ceded;

(g) No cash payment is due from the reinsurer, throughout the lifetime of the reinsurance agreement, with all settlements prior to the termination date of the agreement made only in a "reinsurance account", and no funds in this account are available for the payment of benefits;

(h) The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income reasonably expected from the reinsured policies. A ceding company shall not pay reinsurance premiums, or other fees or charges, to a reinsurer that are greater than the direct premiums collected by the ceding company.

(i) The reinsurance agreement does not transfer all of the significant risk inherent in the business being reinsured.

A risk shall be considered significant if it is:

1. Identified in the representative sampling of products or types of businesses in the "Risk Categories Table"; or

2. Consistent with the representative sampling of products or types of business identified in the "Risk Categories Table".

(j)1. Except as provided by subparagraph 2 of this paragraph, the credit quality, reinvestment, or disintermediation risk is significant for the business reinsured, and the ceding company does not transfer the underlying assets to the reinsurer, legally segregate the assets in a trust or escrow account, or otherwise establish a mechanism satisfactory to the executive director which legally segregates, by contract or contract provision, the underlying assets.

2. Assets supporting the reserves for the following classes of business and any classes of business that do not have a significant credit quality, reinvestment, or disintermediation risk may be held by the ceding company without segregation:

a. Health insurance - LTC/LTD;

b. Traditional nonpar permanent;

c. Traditional par permanent;

d. Adjustable premium permanent;

e. Indeterminate premium permanent;

f. Universal life fixed premium excluding dump-in premiums.

3. The formula for determining the reserve interest rate adjustment shall:

a. Reflect the ceding company's investment earnings;

b. Incorporate all realized and unrealized gains and losses reflected in the statutory statement; and

c. Be calculated as follows:

$$\text{Rate} = \frac{2(I + CG)}{X + Y - I - CG}$$

Where: I is the net investment income.

CG is capital gains less capital losses.

X is the current year cash and invested assets plus investment income due and accrued less borrowed money.

Y is the same as X but for the prior year.

(k) Settlements are made less frequently than quarterly, or payments due from the reinsurer are not made in cash within ninety (90) days of the settlement date;

(l) The ceding insurer is required to make representations or warranties not reasonably related to the business being reinsured;

(m) The ceding insurer is required to make representations or warranties about future performance of the business being reinsured;

(n) The reinsurance agreement is entered into for the principal purpose of producing significant surplus aid for the ceding insurer. All of the significant risks inherent in the business reinsured are not transferred and, in substance or effect, the expected potential liability to the ceding insurer remains basically unchanged.

(o)1. Renewal expense allowances provided or to be provided to the ceding insurer by the reinsurer in any accounting period, are not sufficient to cover anticipated allocable renewable expenses of the ceding insurer on the portion of the business reinsured, unless a liability is established for the present value of the shortfall.

2. The liability shall be established by using assumptions equal to the applicable statutory reserve basis on the business reinsured.

3. Anticipated allocable renewal expenses shall include commissions, premium taxes and direct expenses such as billing, valuation, claims and maintenance expected by the company at the time the business is reinsured;

(2) An insurer may, with prior approval of the executive director of Insurance, take reserve credit or establish any asset that the Executive Director of Insurance has determined is consistent with the:

(a) Insurance code;

(b) Administrative regulations of the Office of Insurance;

(c) Actuarial Standards of Practice of the Actuarial Standards Board.

Section 3. (1)(a) An agreement, including a subsequent amendment to an agreement, entered into after the effective date of this administrative regulation that involves the reinsurance of business issued prior to the effective date of the agreement shall be filed by the ceding company with the executive director within thirty (30) days from its date of execution.

(b) A filing shall include data detailing the financial impact of the transaction.

(c) The ceding insurer's actuary who signs the financial statement actuarial opinion in the annual statement with respect to valuation of reserves shall consider this administrative regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with the office.

(d) The actuary shall:

1. Maintain adequate documentation;

2. Upon request, describe the actuarial work performed for inclusion in the annual and quarterly financial statements; and

3. Upon request, demonstrate that such work conforms to this administrative regulation.

(2)(a) An increase in surplus net of federal income tax resulting from arrangements described in subsection (1) of this section shall be identified separately on the insurer's statutory annual and quarterly financial statement as a surplus item, "aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account".

(b) Recognition of the surplus increase as income shall be reflected on a net of tax basis in the "reinsurance ceded" line as earnings emerge from the business reinsured.

Section 4. Written Agreements. (1) If an agreement, amendment, or letter of intent has not been duly executed by both parties no later than the "as of date" of a financial statement, a reinsurance agreement, or amendment to an agreement, shall not be used to reduce a liability or establish an asset in a financial statement filed with the office.

(2) A reinsurance agreement or an amendment to a reinsurance agreement shall be executed within a reasonable period of time not exceeding ninety (90) days from the execution date of the letter of intent, in order for credit to be granted for the reinsurance ceded.

(3) The reinsurance agreement shall contain provisions which provide that:

1. The agreement shall constitute the entire agreement between the parties with respect to the

business being reinsured and that there are no understandings between the parties other than as expressed in the agreement; and

2. Any change or modification to the agreement shall be null and void unless made by amendment to the agreement and signed by both parties.

Section 5. Existing Agreements. An insurer may continue to reduce liabilities or establish assets in financial statements filed with the Office of Insurance for reinsurance ceded under types of reinsurance agreements described in Sections 1(2) and 2 of this administrative regulation if:

(1) The agreements were executed and in force prior to the effective date of this administrative regulation;

(2) A new business is not ceded under the agreements after the effective date of this administrative regulation;

(3) The reduction of the liability or the asset established for the reinsurance ceded is reduced to zero:

(a) 1994 by December 31, 1994; or

(b) A later date approved by the Executive Director of Insurance pursuant to an application made by the ceding insurer prior to December 31 of the year in which this administrative regulation becomes effective;

(4) The reduction of the liability or establishment of the asset is otherwise permissible under all other applicable provisions of the insurance code, administrative regulations of the Office of Insurance, or Actuarial Standard of Practice of the Actuarial Standards Board; and

(5) The Office of Insurance is notified within ninety (90) days following the effective date of this administrative regulation of the existence of the reinsurance agreements and all corresponding credits taken in the ceding insurer's 1990 annual statement.

Section 6. Risk Categories Table. (1) Significance or risk categories shall be determined by the Risk Categories Table established by this section.

(a) Morbidity.

(b) Mortality.

(c) Lapse.

(d) Credit Quality.

(e) Reinvestment.

(f) Disintermediation.

(2) Classes of Insurance Business	Risk Categories					
	a	b	c	d	e	f
Health Insurance - other than LTC/LTD*	+	0	+	0	0	0
Health Insurance - LTC/LTD*	+	0	+	+	+	0
Immediate Annuities	0	+	0	+	+	0
Single Premium Deferred Annuities	0	0	+	+	+	+
Flexible Premium Deferred Annuities	0	0	+	+	+	+
Guaranteed Interest Contracts	0	0	0	+	+	+
Other Annuity Deposit Business	0	0	+	+	+	+

Single Premium Whole Life	0	+	+	+	+	+
Traditional Nonpar Permanent	0	+	+	+	+	+
Traditional Nonpar Term	0	+	+	0	0	0
Traditional Par Permanent	0	+	+	+	+	+
Traditional Par Term	0	+	+	0	0	0
Adjustable Premium Permanent	0	+	+	+	+	+
Indeterminate Premium Permanent	0	+	+	+	+	+
Universal Life Flexible Premium	0	+	+	+	+	+
Universal Life Fixed Premium	0	+	+	+	+	+

Where:

+ = significant risk

0 = insignificant risk

*LTC = long-term care

*LTD = long-term disability

a. Lapse is the risk that a policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.

b. Credit Quality is the risk that invested assets supporting the reinsured business will decrease in value. Credit Quality does not include market value declines due to changes in interest rates.

c. Reinvestment is the risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will earn less than expected.

d. Disintermediation is the risk that policy loans and surrenders increase, or maturing contracts do not renew at anticipated rates of renewal, during a period of increasing interest rates. (18 Ky.R. 958; eff. 11-8-91; Am. 22 Ky.R. 1741; 2033; 23 Ky.R. 137; eff. 7-5-96; TAm eff. 8-9-2007.)